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Agenda Item 3

May 16, 2011

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: April 2011 Policy Subcommittee Report

II. PROGRAM: Total Fund

III. RECOMMENDATION: That the Investment Committee approve the following:

a. Policies relevant to adoption of new asset classifications, asset allocation mix, and asset class ranges.
   1) Adoption of Policy on Liquidity Program
   2) Revision of Policy on Asset Allocation Strategy
   3) Revision of Policy on Benchmarks
   4) Adoption of Policy on Inflation Assets and its Components: Commodities and Inflation-Linked Bonds
   5) Adoption of Policy on Real Assets and its Components: Real Estate, Forestland, and Infrastructure; and repeal of policies on Inflation-Linked Asset Class (ILAC) and Real Estate

b. Repeal of Policy on Directed Brokerage Arrangement

IV. ANALYSIS:

In April 2011, policy changes were proposed to reflect the recent asset allocation targets and ranges approved by the Committee in December 2010. At the Policy Subcommittee meeting, there were comments from the Subcommittee regarding the content and format of the policies. Administrative issues, including hyper-linking and template language, will be addressed at the June Policy Subcommittee meeting. Ministerial content changes made to the policies, including revisions requested by the Subcommittee, are summarized in the individual policy sections listed in this item.

Following the April meeting, the Liquidity Program Policy (attachment 1) incorporated substantive changes, and explanation of this revision is included below.

Adoption of Policy for Liquidity Program

At the December 2010 Investment Committee meeting, the Committee approved the adoption of a new asset allocation plan which included the expansion of an existing asset category called capitalized cash and renamed it Liquidity. Within this category are two portfolios: US Treasury 2-10 Year Program (UST Program) and Internally Managed Dollar-Denominated Short Term Program (ST Program). The ST Program language was extracted and deleted out of the existing Policy for Low Duration.

No further changes were made to the Low Duration Fixed Income Program policy.

The new Liquidity Policy used the extracted ST language and placed it directly into this new policy (Attachment B in the Liquidity Policy). The removal of tri-party purchase agreements from the list of restrictions and prohibitions was the only revision made to this attachment (Attachment B section II.D.8.). The other section, UST Program, is located in Attachment A in the Liquidity Policy. This is a new portfolio and strategy that intends to restrict securities to liquid U.S Treasury and STIF funds.

Duration ranges are allowed to be +/- 10% similar to the domestic fixed income programs. The expectations for alpha and flexibility ranges within the policy for UST Program are purposely low to facilitate the high liquidity requirement of the Liquidity Program.

Previously, Staff included ranges for the total Liquidity Program. The total program ranges of 1% to 7% with a target of 4% were approved by the IC during the asset allocation process. Following the April Policy Subcommittee meeting, staff added detail, regarding ranges, for the subcomponents of the program (ST and UST Programs). Ranges and targets will be expressed in terms of total fund percentages. Staff suggests ranges for the short term section to be 0% to 2% and for the U.S. Treasury 2-10 Year Program to be 1%- 5%. This content has been incorporated into § V. (Investment Approaches and Parameters). Revisions made to the content of this policy have been reviewed by the CIO, COIO, SIO of Asset Allocation and Risk Management and Wilshire.

Revision of Policy for Asset Allocation Strategy

The revised Statement of Investment Policy for Asset Allocation includes revised asset allocation targets and ranges.

Wilshire opined on these policy revisions.

No revisions were made to the content of this policy following the April Policy Subcommittee meeting.

Revision of Policy for Benchmarks

The revised Statement of Investment Policy for Benchmarks incorporates new asset classification structure for Total Fund. In addition, staff updated the benchmarks for Global Equity, AIM, Real Estate, Inflation-Linked Bond, Infrastructure, SIP CalPERS Risk-Based and Target Retirement Date Funds Policy.

Revisions made to the content of this policy following the April Policy Subcommittee meeting include substituting “Real” with “Real Assets” throughout the policy and including Board responsibilities relating to setting benchmarks. Also, Attachment H (Benchmarks for Investment and Risk Management) was removed as requested by the Subcommittee because the information was neither applicable nor quantitative.

Adoption of Policy on Inflation Assets and its Components: Commodities and Inflation-Linked Bonds

This policy reflects the extraction of the Infrastructure and Forestland Programs out of the Inflation-Linked Asset Class (ILAC). These Programs were moved into Real Assets, leaving the Commodities and Inflation-linked Bond Programs in the Inflation Assets Policy. The previous policy, the Statement of Investment Policy for Inflation-Linked Asset Class, will be repealed upon adoption of this item.

Wilshire opined on these policy revisions.

No revisions were made to the content of this policy following the April Policy Subcommittee meeting.

Adoption of Policy on Real Assets and its Components: Real Estate, Forestland, and Infrastructure; and repeal of policies on Inflation-Linked Asset Class (ILAC) and Real Estate

In December 2010, the Investment Committee (“Committee”) approved an alternative asset classification as part of the overall asset allocation process. The approved classification called for the creation of a new Real Assets class comprised of the Real Estate program, and the Infrastructure and Forestland programs from the Inflation-Linked Asset Class.

In February 2011, the Committee approved a new Strategic Plan for Real Estate and in February and March 2011, Staff developed a single overarching Real Assets policy to govern the consolidated program. As part of the consolidation process, Staff is requesting repeal of existing policies for the Inflation-Linked Asset Class and Real Estate Program. Staff also outlined in the previous agenda item the program's plans for transitioning into and implementing the new policy.

Staff believes a single overarching policy will provide more effective policy directives and controls on investment activities for the new Real Assets class. The previous overarching policy, the Statement of Investment Policy for the Real Estate Program, will be repealed upon adoption of this item.

The General Pension Consultant, Wilshire; Real Estate Consultant, Pension Consulting Alliance; and Infrastructure Consultant, Meketa; have opined on these policy changes.

Upon the Subcommittee's request, revisions were made to the policy following the April 2011 Policy Subcommittee meeting. In Attachment A § III.A.2, the language now reads, "Explanations of variances and notice of non-compliance, if any;" instead of "Notice of non-compliance, if any." Also, in attachment A § V.G.3.c, "Urban Mixed-Use," located on the table has been changed to "Mixed-Use."

Repeal of Policy on Directed Brokerage Arrangement
The Statement of Investment Policy for Directed Brokerage Arrangement (Policy) was designed to provide guidance regarding the collection and use of funds related to the recapture of commissions paid by CalPERS to brokers. Since its inception in 2002, the Policy has decreased in utilization, has become less cost effective, and the funding made available for research and analysis through these arrangements has decreased by 77.4%. Most importantly, over the last few years the industry best practice has been to completely eliminate these types of arrangements. In an effort to align with best practices, increase transparency in expenditures, and improve cost effectiveness, INVO recommends that the Policy be repealed as of June 30, 2011, with a sunset date of September 30, 2011.

V. STRATEGIC PLAN:

Approving these policy adoptions, revisions, and repeals will uphold the following CalPERS strategic goals:

I. Exercise global leadership to ensure the sustainability of CalPERS pension and health benefit systems.

VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

IX. Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

The results of this item will provide CalPERS with the enhanced efficiencies and ability to manage the overall portfolio. The policies will provide a foundation for compliance, accountability, and transparency.

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